This document corrects the title to and replaces the memorandum of March 17, 2005.

State of California

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Memorandum

To: Honorable John Chiang, Chairman
Honorable Claude Parrish, Vice-Chairman
Ms. Betty T. Yee, Acting Member
Honorable Bill Leonard
Honorable Steve Westly, Controller

Date: March 21, 2005

From: Ms. Kristine Cazadd (MIC: 82) K Cazadd
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Subject: **Board Member Leonard's Proposal to Exclude Emission Reduction Credits as a Component of the Cost Approach Value Indicator in the Valuation of State-Assessed Electric Generating Facilities, Property Tax Committee Meeting March 22, 2005.**

This memorandum presents Board Member Bill Leonard's request that the Property Tax Committee review the current Valuation Division staff practice of assessing the cost of emission reduction credits (ERCs) as an intangible attribute of improvements in state-assessed electric generation facilities and instead determine that ERCs are nontaxable intangible assets and rights which must be excluded as a component of the cost approach value indicator. In a prior memorandum from Chief Counsel Timothy W. Boyer to the Board dated October 22, 2004, the Board staff opined that ERCs are properly classified as *intangible attributes* of the improvements under Revenue and Taxation Code[1] section 110, subdivision (f), and should be included in the value of the improvements when necessary for the construction and operation of an electric generation facility. However, when ERCs are "banked", they are properly classified as *nontaxable intangible assets and rights* within the meaning of section 110, subdivision (e), and may not be included in the value of the property.

Board Member Leonard believes that the staff's opinion falls short of certain factual and legal realities, and proposes that the Property Tax Committee, at the meeting scheduled for March 22, 2005, adopt a policy under which all ERCs remain nontaxable. In effect, ERCs would be treated *as intangible assets and rights* and excluded as a component of the cost approach value indicator with appropriate adjustments in the income indicator in the valuation of state-assessed electric generating facilities. Such a policy is reasonable and within the parameters of the detailed discussion in the Assessors' Handbook section 502, *Advanced Appraisal.* Pages 150 through 165 state in numerous contexts that section 110, subdivision

[1] All section references are to the Revenue and Taxation Code.

(d) requires that an appraiser must identify any nontaxable intangible assets and rights such as goodwill, licenses, franchises, the right to do business and certain permits, and exclude them from the value of the taxable property.

New Factual Background for Classification of ERCs for Property Tax Assessment

ERCs are "emission reduction offsets" administered by air pollution control districts throughout the State, which are used only when necessary to mitigate the effects of emissions from stationary, mobile and area sources in a particular district. Whenever a new stationary source, such as an electric generation facility, locates or is constructed, the source operator must apply for an "authority to construct permit" and a "permit to operate" from the local air pollution control district. The new or modified source must demonstrate that it meets that district's program regulations regarding BACT and emission offsets. If the district finds that the potential of the source will emit nonattainment pollutants equal to or above that specified by the state or local regulations, the district will require the source to provide offsets, at a level required to mitigate the emissions. If on the other hand, the district finds that the construction of the facility will not exceed acceptable levels of nonattainment pollutants, then no offsets are required since mitigation is unnecessary. Thus, it appears that the source operator actually has three alternatives (rather than two as indicated in the October 22, 2004 memo). The source operator may either 1) purchase ERCs, or 2) install pollution control equipment, or 3) construct the facility without either ERCs or pollution control equipment.

In the assessment of electric generating facility properties, the Valuation Division staff has followed the October 22, 2004 memorandum, by classifying ERCs as *intangible attributes* of the improvements necessary for the construction and operation of the facility. Staff's view was based on the premise that ERCs may be treated as intangible attributes under section 110, subdivision (f) because they appear to be the functional equivalent of air pollution control equipment otherwise required to be installed. Staff does recognize that ERCs that are "banked" and are not being used by an electric generation facility are not necessary for its operation, and for that reason, are properly classified as nontaxable *intangible assets and rights* under section 110, subdivision (e).

The alternate premise proposed by Mr. Leonard however, is that ERCs are nontaxable intangible property within the meaning of Article XIII, section 2 of the California Constitution. Therefore, they should be treated as *intangible assets and rights* under section 110, subdivision (e). In character, ERCs are the functional equivalent of permits (similar to conditional use permits for billboards) or licenses (e.g. liquor licenses) that are treated as nontaxable intangible property by courts and by the Board.

Treatment of ERCs as Nontaxable Intangible Assets and Rights

Under the California Constitution, intangible property is exempt from property taxation, *ITT World Communications, Inc.* v. *County of Santa Clara* (1980) 101 Cal.App.3d 246, 254. ERCs are properly classified as intangible assets and rights within the meaning of Revenue and Taxation Code section 110, subdivision (d) which generally provides that "[t]he value of intangible assets and rights relating to the going concern value of a business using taxable property shall not enhance or be reflected in the value of the taxable property." Based on the

constitutional and statutory definitions, ERCs are analogous to liquor licenses or billboard use permits and are, thus, exempt from property taxation whether they are "used" or "banked." There is no conflict between the Revenue and Taxation Code provisions and the California Constitution or the Assessors' Handbook section 502, in this regard.

The current staff policy of treating ERCs as *intangible attributes* and including them in the taxable value of any property (including electric generation facilities) violates the Constitution and the statutory law. Moreover, the staff policy is not legally defensible because it is inconsistent with published court decisions, *Michael Todd* v. *County of Los* Angeles (1962) 57 Cal.2d 684, and *Western Title Guaranty Co.* v. *County of Stanislaus* (1974) 41 Cal.App. 3d 733. Taxpayers have raised the issue of the taxability of ERCs in several recent property tax appeals, but it has not yet been resolved. If a taxpayer brings a legal challenge, the current staff policy will prove difficult to defend in court because of the compelling case law and the constitutional prohibition. The Board should adopt a clear policy that complies with the Constitution (as well as its own published advice) without waiting for a court order and risking the expense of litigation.

Proposal to Exclude Emission Reduction Credits as a Component of the Cost Approach and to Make Adjustments in the Income Indicator in the Valuation of State-Assessed Electric Generating Facilities

Board Member Leonard has proposed that the Board, through the Property Tax Committee, adopt a policy under which staff would exclude ERCs as a component of the cost approach value indicator in the valuation of state-assessed electric generating facilities. Board Member Leonard's proposal is based on the position that ERCs are nontaxable intangible property. Staff's current valuation approach includes ERCs in the taxable property and thereby violates the California Constitution and the Revenue and Taxation Code, as interpreted by the California Court of Appeal and Supreme Court, which prohibits the taxation of intangible property. In addition, property tax appraisal principles require the exclusion of ERCs in the determination of the fair market value of taxable property.

The Board's appraisal guidelines state that the fair market value of property for property tax assessment purposes must exclude nontaxable assets. Although the effect appears to be revenue-reducing, in practice, the fiscal implications of this tax policy are minimal, if the valuation methodologies are properly reconciled and applied. As stated in the AH 502, the appraiser must value property at its highest and best use. It is a matter of both law and primarily a matter of principle, that highest and best use does not imply "that the taxable property has an assessed value over and above its market derived value due to the presence of the intangibles necessary to productively use the taxable property." (AH 502, p.159.) This principle is an important one, and one that is clearly stated in the Board's own publications, including letters to assessors and assessors handbooks.[2]

Pursuant to section 110, subdivision (d)(2) the nontaxable value of those rights must be removed from the cost approach value indicator in the determination of the value of the taxable property. In estimating the value of the nontaxable property, an appraiser must consider the purpose of the particular intangible assets. In other words, the fair market value

[2] AH 502, pp. 154-155.

of the taxable electric generation facility property must not include the nontaxable value of the ERCs to the extent that the value of the ERCs is ascertainable. In that regard, the costs of the ERCs represent the value of the ERCs and the value is ascertainable as a component of the cost approach value indicator. Thus, the costs of the ERCs would not be included in the cost approach value indicator, resulting in a reduction in the value determined by that indicator.

If the intangible value of the ERCs were properly estimated, the staff would determine that the costs of ERCs are a very minor portion of the costs of electric generating facilities. For facilities valued by the cost approach indicator excluding them would marginally reduce the assessable value. Instead, staff's current method uses a "mass appraisal" approach resulting in a value of $5400 per megawatt, that does not adequately account for the differences in ERC costs in the various air pollution control districts throughout the state (some of which do not even require ERCs). Furthermore, this methodology does not reflect all of the risks and government intervention involved in the ERC market, nor does staff have adequate appraisal knowledge and information about the unique circumstances inherent in this market. Finally, staff's method is not be consistent with the Board's advice in AH 502, p. 150, 153-154, requiring that the final value indicator must not include any nontaxable value.

With regard to the income method, the staff must explain any adjustments that would be necessary for power plants that are valued by the income approach, which is the preferred valuation method for these unitary properties. That is, if a portion of the income stream is attributable to the intangible value of the ERCs, then staff should explain the application of Property Tax Rule 8, subsection (e) as described in the Assessors' Handbook section 501. Alternatively, staff should explain the methodology for removing the value of the ERCs from the income indicator after the stream has been capitalized. Furthermore, in the event that a plant has purchased high value ERCs, even though the plant itself is not generating sufficient income to produce an adequate rate of and on return to the subject property, then staff must explain that the assessment cannot be salvage or scrap value, but must reflect the fair market value by either reconciling income with more reliable data or by selecting a valuation approach that requires fewer adjustments. AH 502, p.164, *Michael Todd v. County of Los* Angeles (1962) 57 Cal.2d 684.

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